Office-Supreme Court, U.S.
FILED
JUN 27 19
ALEXANDER L. STEVAS,
CLERK

83-59
No. 82-

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

American International Coal Co., Inc., Petitioner,

v.

Commissioner of Internal Revenue, Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

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## QUESTIONS PRESENTED

1. Whether the petitioner was entitled to deduct on its corporate federal income tax return commissions paid to a salary employee for services rendered, which produced substantial sales and profits for the petitioner.

2. Whether the court of appeals erred in affirming the tax court's decision setting aside a termination agreement characterizing a $50,000 payment by the petitioner to the terminating employee, a fifty percent shareholder, as compensation for services rendered when the lower court in its own language recognized and admitted the valuable nature of the employee's services, but held that the employee's services solely increased the value of the petitioner's stock and the employee was not entitled to any additional compensation for the

services other than his salary of $8,600 at the time of termination.

3. Whether the U. S. Treasury should be unjustly enriched by the inconsistent position of the Commissioner of the Internal Revenue in this case, to wit, collecting revenue from the petitioner by claiming a disallowance of a compensation payment after it has already collected revenue from the employee treating it as a compensation payment for Federal income tax purposes.

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IN THE

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No. 82-

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American International Coal Co., Inc., Petitioner,

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# PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Petitioner, American International Coal Co., Inc., prays that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Third Circuit affirming a judgment of the United States Tax Court.

## OPINIONS BELOW

The Judgment Order and Sur Petition for Rehearing of the United States Court of Appeals for the Third Circuit are not yet reported; they are set forth as Appendix A and B respectively, infra pp. 1a thru 4a. The opinion of the Tax Court is reported at 43 TCM 1097; Dec. 38, 947(m); T.C. Memo 1982-204.

## JURISDICTION

The judgment by the United States Court of Appeals for the Third Circuit was entered on March 8, 1983. (Appendix A, infra. pages 1a and 2a). On March 31, 1983, the Court of Appeals denied a timely petition for rehearing (Appendix B, infra pages 3a and 4a. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1).

## STATUTE INVOLVED

Section 162(a)(1) of the Internal Revenue Code provides:

> (a) In General - There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including-
>
> > (1) A reasonable allowance for salaries or other compensation for personal services actually rendered.

## STATEMENT

This case is not one of reasonableness of compensation but arises out of a Termination Agreement, dated October 3, 1975, a copy of which is set forth as Appendix C infra p. 5a, between American International Coal Co., Inc. ("American" or petitioner) a Pennsylvania corporation engaged in the coal brokering business in Pittsburgh, Pennsylvania and Stephen C. Levitt ("Levitt"), an employee and a fifty percent shareholder of American. At the time of termination, Levitt had received from American for services rendered monthly salary payments totaling $8,600 and was solely responsible for producing profits in excess of $100,000 in his capacity as president and chief executive officer of American. Levitt was essentially the only employee of

American. The terms of the agreement provided a $50,000 payment to Levitt as "payment of commissions due Employee for services rendered to Employer." Levitt was represented by legal counsel (Robert Cindrich) during the negotiations while American was represented by the other fifty percent shareholder, Richard C. Schomaker ("Schomaker"). There was not any evidence showing Levitt possessed any operating losses or other unusual tax attributes, which would render any tax allocation meaningless to him. Moreover, the Government was not losing any significant revenue as a result of the parties characterization of the payment. However, in using the judicial doctrine of the substance of a transaction prevails over the form of it, the Tax Court, (affirmed by the appellate

court) set aside the Termination Agreement and ruled that the $50,000 payment to Levitt represented a redemption of his fifty percent stock interest in American. The lower court so held even though the terms of the agreement were the result of arm's length bargaining between the parties, and the overall structure of the arrangement was dictated by a legal liability on the part of American to pay Levitt a commission as a result of rendered services which caused American to have increased sales and profits during the period of time Levitt was solely managing and operating the corporation. American was obligated and bound to pay the commissions even in absence of the written agreement.

During the first year of its operations in 1975, American was engaged only

in the business of supplying coal under contract, i.e., the brokering of coal. Profits of American were solely dependent upon the securing of contracts for the purchase of coal at a price greater than the costs and expenses of shipping coal directly from the suppliers to the users of coal. On March 20, 1975, West Penn Power Company ("West Penn"), a large utility company serving the Pittsburgh area and a user of coal, entered into a forty-five month contract with American to provide a certain quality of coal at a total contract price of $19,980.00. Levitt was principally responsible for the successful negotiation and execution of the coal contract on behalf of American. However, the coal contract was meaningless and worthless without the proper quantity and quality of coal. As

a result, Levitt spent numerous hours by himself in finding coal suppliers to ship the right type of coal to West Penn. He worked out in the fields every day buying coal, making arrangements, meeting coal miners and owners of the mine. Although Levitt experienced many problems with suppliers providing the correct quantity and quality of coal to West Penn, he was quite successful in producing the only profits for American which according to his calculations were in excess of $100,000 during the period of time from January 1975 until September 23, 1975, the day of Levitt's departure.

On September 23, 1975, Levitt was abruptly taken into protective custody under the federal witness protection program without an opportunity for either Schomaker or Levitt to make ar-

rangements for someone to succeed him. At that time, Levitt had received monthly salary payments totalling $8,600 and obviously wanted additional sums based upon his successful, but brief career with American. With this in mind, Levitt prepared a check for $50,000 payable to himself, drawn on American's bank account, labelled it on the check stub as "for the purchase of stock of Stephen C. Levitt" and had it presented to Schomaker for his countersignature. The check was not negotiable unless Schomaker also placed his signature on it. On the check stub, Levitt placed the words "For the purchase of the stock of Stephen C. Levitt." Levitt did not know at this time whether his interest in American should be characterized as commissions or stock although he understood the difference in

the tax consequences between the two.

Schomaker refused to sign the check and explained to the messenger that he did not know how to operate the Company at all. Later, in a brief private meeting, Schomaker told Levitt that he could not sign the $50,000 check "the way it was." Levitt did not object but responded by saying that his attorney, Robert Cindrich would conclude the negotiations for terminating Levitt's interest in American. On Cindrich's advice, Levitt executed a general power of attorney authorizing his brother-in-law, Richard M. Handler ("Handler") to handle all of his financial affairs.

Subsequently, Cindrich and Schomaker met to discuss the terms of the withdrawal of Levitt as an employee and shareholder of American. Schomaker's

position was that since Levitt was solely responsible for the net profits of in excess of $100,000 and assets of American at the time of his departure, he was entitled to commission compensation for these valuable services which were responsible for the only sales and profits of American. Moreover, the West Penn coal contract, the principal source of revenue for American during Levitt's career with American, was an executory contract in that the right coal had to be found for shipment by suppliers, which was a serious problem when Levitt was solely operating the Company. The West Penn coal contract had contingent value, which at the time of Levitt's termination of services was not only unascertainable but also of little value, if any, because of the lack of an exper-

ienced successor to Levitt. Levitt recognized the limited and nominal value of the West Penn contract when he only wanted $50,000 based upon American's cash position of "$100,000 plus" at the time he drew the check. He requested no additional sums for the future value of the contract.

Both Levitt and Schomaker had earlier manifested their intention of the manner of treating the services rendered by Levitt. Before the incorporation of American, a Pre-Incorporation Agreement, a copy of which is set forth as Appendix D, p. 9a, dated December 5, 1974 was entered into by Levitt, Schomaker and another party who shortly thereafter was not associated with American. Article 3 of the agreement provided that:

> "If any party to the Agreement performs services in excess of

> those services rendered by the other shareholders, he shall be compensated on a reasonable basis in addition to his proportion of the net profits."

This agreement was still in effect at the time of Levitt's termination.

Final negotiations on terms of the Termination Agreement began on or about September 25, 1975 and ended on October 3, 1975. Intensive discussions about all terms of the arrangement were carried on between Schomaker and Cindrich. Moreover, although Cindrich and Handler had authority to negotiate Levitt's withdrawal as an employee-shareholder of American, Cindrich communicated Schomaker's offer to Levitt, who did not complain about the characterization of the payments as commissions and was satisfied with the characterization even though Cindrich advised him that the payment was to be reported

for tax purposes as ordinary income. Final approval was granted by Levitt, which paved the way for Cindrich to draft two documents, one entitled "Termination Agreement" characterizing the $50,000 payment as compensation for services rendered and the other "Agreement of Sale", a copy of which is set forth as Appendix E, p.12a providing for a redemption of Levitt's fifty percent stock interest for one thousand dollars.

The Termination Agreement, dated October 3, 1975, describes in the preamble that Levitt was previously employed by American as President, General Manager, and Sales Representative and had "consummated various sales of coal...which resulted in earnings and profit" to American. The language continues by averring that Levitt "is entitled to commissions on

said sales as set forth herein..." Paragraph number one provides for a $50,000 payment to Levitt for services rendered to American and paragraph three asserts that Levitt accepted the sum "as full and complete satisfaction of any and all amounts due to him...for services rendered in connection with Employer's (American's) coal brokerage business."

On October 3, 1975, these two agreements were signed by Schomaker on behalf of American and by Handler on behalf of Levitt. On or about the same day, Schomaker then countersigned the $50,000 check originally prepared by Levitt. Upon countersigning it, he changed the notation on the check stub by crossing out the words "for the purchase of the stock of Stephen C. Levitt" and substituted the word "commissions". In addition, Schomaker crossed out the original entry

in American's check register for the check under a column headed "in payment of" in which Levitt had entered "purchase of stock", and he inserted the word "commissions". He then delivered the check to Cindrich for transmittal to Levitt.

American prepared a form 1099 showing commission payments of $54,800 to Levitt as commissions and sent copies to the Government and Levitt. (The $54,800 represents the $50,000 check payment to Levitt plus $4,800 of consulting payments made to Levitt after his departure, which are not in issue in this appeal).

Years after the execution of the Termination Agreement, Levitt confirmed and verified his understanding of the characterization of the $50,000 payment. Pursuant to a request by the Commissioner, Levitt executed a Certificate

dated March 28, 1979 establishing that he believed that the payments in question to him were ordinary commissions taxed at ordinary income tax rates and not for payment of stock. Moreover, a supplemental certificate signed by Levitt on March 24, 1980, explains that the $50,000 payment received by him from American in 1975 was reported on his 1975 Federal Individual Income Tax Return Schedule C as ordinary income and not as capital gain. The Internal Revenue Service has accepted the 1975 tax return of Levitt with respect to the characterization of the payments as commissions under the terms of the Termination Agreement. Moreover, Levitt has never filed for or received a refund of taxes from the Treasury for the Commissioner's inconsistent position

that the payments represent a redemption of stock subject to taxation at capital gains rate, and the period of time has expired for Levitt to file a refund for the 1975 taxes paid to the Federal Government.

After Levitt's departure, Schomaker all but abandoned his law practice and devoted most of his time to the conduct of American's business. Schomaker was very inexperienced in the coal brokering business and did not know of anyone else in the coal business at the time of Levitt's departure or during the negotiations of the contract with Cindrich or shortly thereafter who could aid or assist him in the operations of American. Schomaker had nothing to do with any of the profits of American when Levitt was the Chief Executive Officer and respons-

ible for the day-to-day operations of American.

As a result of Schomaker's inexperience in the coal business, American eventually had to employ Jack Sedlack ("Sedlack") in November, 1975. Sedlack had some background in the coal business and assisted in managing American's business operations with Schomaker.

At the time of Levitt's departure, there were six suppliers furnishing coal to West Penn under the coal contract, all as a result of Levitt's efforts. By January, 1976, of these six suppliers, there was only one remaining supplier shipping coal. After Schomaker assumed the responsibility for the operations of American, the profits were down for the remaining parts of the 1975 calendar year. In fact, the income state-

ment for 1975 showed a loss for that year even though Schomaker worked vigorously to keep the company viable with the help of Sedlack. On its income tax return for 1975, American deducted the $50,000 payment to Levitt as commissions, which the Commissioner disallowed.

In holding that the Termination Agreement and Agreement of Sale do not reflect the substance and reality of the transaction, the lower court found the nature of the $50,000 payments to Levitt to be a redemption for his 1000 shares of American stock.

The lower court recognized the existence and valuable nature of Levitt's services and never denied that they occurred.

> "Many of the facts cited by petitioner (American) to show the value of Levitt's services, however, tend also to show that petitioner's

> stock had substantial value when Levitt left Pittsburgh, and they indicate that most (if not all) of the payment called for in the Termination Agreement was, in fact, paid to redeem his stock."

Moreover, in reaching its decision, the court relied upon oral evidence of Levitt culled from the record which contradicted the terms of the written Termination Agreement and certificates supporting the characterization of the payment as commissions. In essence, the court relied upon its own perception of the transaction without any discussion or consideration of the undisputed facts supporting the terms of Termination Agreement. The court undertook its own evaluation of certain selected facts showing that American was a going concern corporation and had a valuable asset in the West Penn coal contract. Despite

clear findings to the contrary, it adopted the conclusion that since "this was the price he (Levitt) asked for his stock based on his knowledge of the company's assets and liabilities," the $50,000 payment was in redemption of stock.

The United States Court of Appeals for the Third Circuit without oral argument affirmed the decision of the Tax Court "essentially for the reasons appearing in the opinion of the Tax Court...and that the decision is supported by substantial evidence."

REASONS FOR GRANTING THE WRIT

1. The arrangement in this case was a realistic one motivated by valid business reasons made by the parties on an arm's length basis, and to meet legal requirements. There was no doubt that

Levitt rendered valuable services to American. Yet the lower court strikes it down on a retrospective determination that it was a sham and substitutes its own business judgment for that of the parties. This decision completely misapplies and misunderstands that judicial doctrine that the substance of a transaction rather than the form is the controlling consideration. In applying this principle, the court below refused to give any probative weight to the form of the transaction, which is contrary to the Supreme Court decision in the Frank Lyons Company v. U.S. case.[1] As Justice Blackmum stated some years ago:

> "Form does not have some weight and significance in tax law and

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[1] Frank Lyons Company v. U.S., 1978, 78-1 USTC, Para. 9370, reversing CA-8, 76-1 USTC Para. 9457, 536 F.2d, 746.

> the selection of one route over another to a desired end is often a critical choice and may serve validly to govern the tax effect of a transaction."[2]

The Justice reiterated this viewpoint for the Supreme Court in his written opinion for the majority in the Lyons case, supra, by concluding:

> "In short, we hold that where as here, there is a genuine multiple-party transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations and is not shaped solely by tax-avoidance features that have meaningless labels attached, the Government should honor the allocation of rights and duties effectuated by the parties."

Earlier in the decision, the Court also recognized that the form of a transaction

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[2]Idol v. Commissioner, 391 F.2d 647, 651 98th Cir. 1963).

should govern when there is objective evidence to support it:

> The Court has never regarded 'the simple expedient of drawing up papers'....as controlling for tax purposes when the objective economic realities are to the contrary. (See pp. 83,879 and 83,880)

Even though the Lyons case, supra, involved a three party sale leaseback transaction, the doctrine and principles in that case are applicable here.

In the present case, the lower court never addressed itself to its function under the substance versus form doctrine of examining the intention of the parties with respect to whether there were sufficient facts surrounding the services performed by Levitt to justify and support the conclusion that the $50,000 payment was for commissions under the terms of the Termination Agreement.

The record was replete with facts by both parties to the agreement establishing the extent, nature and quality of Levitt's services which support the $50,000 payment as compensation under the terms of the Agreement.

An examination of the Termination Agreement reveals that every recital was true in fact. Levitt was the "President, General Manager, and Sales Representative" who had in fact "consummated various sales of coal on behalf of American, resulting in earnings and profits to American," and was "entitled to commissions on said sales as set forth in the Agreement." Uncontradicted and unimpeached testimony by both Schomaker and Levitt at the time of trial established that Levitt served in such positions of responsibility for American and had rendered services by

effectuating coal sales, resulting in earnings and profits to American. It would naturally follow that he would be entitled to commissions for such sales. None of these factors was created or fabricated by the parties as in the typical sham transaction. Moreover, the court itself recognized the existence and value of Levitt's services when it claimed in its opinion that Levitt's services caused American's stock to have substantial value. If Levitt's services increased the value of American's stock, they obviously had to be valuable.

The court also refused to give any probative weight to the Pre-Incorporation Agreement dated December 5, 1974 which established an agreement between Levitt and Schomaker to provide additional compensation to a party performing

"services in excess of those services rendered by the other shareholder." This agreement established unequivocally the original intention and understanding of Levitt and Schomaker before any services were performed as to the manner of compensation in the event Levitt performed services in excess of those services performed by Schomaker. The court neglected to consider whatsoever as relevant any aspect of the Pre-Incorporation Agreement which was established over nine months before Levitt terminated services and the resulting Termination Agreement characterizing the payments as commissions.

In the typical sham transaction, facts are artificial and unsupported by objective evidence, causing the courts to invoke the substance versus form doctrine

to strike down the shape of the transaction. In the present case, the lower court erred in its application of the judicial doctrine by arbitrarily ignoring uncontroverted and objective facts supporting the terms of the Termination Agreement by the parties with competing tax interests characterizing the payments as compensation for services rendered. The Lyons case, supra, supports the viewpoint of the petitioner that provided there are "objective economic realities" present, the courts must abide by the shape given the transaction by the parties, particularly when there is not any evidence that the Treasury is losing meaningful revenue from the characterization or allocation agreed to by the parties. Here, there was not any showing by the Commissioner that the

parties were subject to tax at substantially different tax rates or that the Treasury was deprived of revenues from the manner the parties characterize the payment.

For the lower court to say that nevertheless the $50,000 payment was in redemption of Levitt stock interest in American in support of the Commissioner's position, encourages the Internal Revenue Service's unwarranted interference in the business affairs of taxpayers by the substitution of its own business judgment for that of parties structuring a transaction even though the Service possesses less personal knowledge and information of the business deal, particularly values, than the parties. This practice should not be permitted to continue.

2. The lower court's decision in this case places businessmen under a cloud of uncertainty from a financial and strategic planning viewpoint and prevents them from forseeing with any accuracy the effect of the present transactions clearly. In pratically all business transactions, the income tax consequences are analyzed and considered in the determination of the net income result. With taxes often taking fifty percent of net income, taxpayers bargaining at arm's length, attempt to obtain the most favorable tax treatment on each transaction, which is permissible and acceptable within the tax laws. Bracketed with the principle that substance prevails over form in taxation is the almost equally accepted rule that each taxpayer has the privilege of so

ordering his affairs to pay the least tax, and the correlative that one can cast a transaction in the one of several alternative forms which is most advantageous tax wise.[3] Litigation abounds in this area of the tax laws where characterization of a transaction by the parties like the one in the present case is not questioned by the parties but is attacked by the Internal Revenue Services. It is an appropriate function of this court to provide guidance and clarification in this area of the tax laws to the lower courts, lawyers and government officials who are engaged in the administration of the tax laws. This is particularly the case where the question

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[3]Helvering v. Gregory, (1934 CCH para 9180), 69 F.2d 809, 810 (2d Circuit 1934) affirmed (35-1 USTC para. 9043) 293U.S. 465.

is one of importance on which the business community and lawyers need light so that intelligent planning and implementing of transactions may occur on a basis of reasonable assurance without the inevitability of controversy and litigation in each transaction from the Internal Revenue Service.

In the present case, each party involved in the characterization of the $50,000 payment had conflicting tax interests. Levitt preferred an allocation of all payments to the purchase of stock with taxation of the gain at the favorable capital gains rate while American would be unable to receive a deduction unless the entire payments were allocated as compensation for the employment services of Levitt. The record lacks any evidence showing that

Levitt possessed any unusual tax attributes such as a net operating loss which would make any tax allocation meaningless to him. The parties considered the income tax consequences in bargaining for the price to be paid. If American had known that the $50,000 payment was not deductible (which is the result of the decision below), the price paid to Levitt would have been adjusted accordingly. To deny the deduction now places American in a trap and as explained in the next section produces a windfall for the federal government by the adoption of an inconsistent position. The understanding that the $50,000 payment could be deducted by American was a basis on which the negotiation between Schomaker and Levitt were conducted and transpired. The bargain negotiated

between the parties was completely changed from their intentions without any substantive justification.

The situation in the present case is comparable to that which existed in the sale and leaseback arrangements when this Court granted certiorari and decided Frank Lyon Company v. U.S., supra. After the Court clarified the basic principles, the decision substantially limited litigation and administrative controversy. In the absence of a clarifying decision by this Court, multiplication of litigation in the lower courts is inevitable and the thwarting of business plans can be expected to continue. Prognostication of how some court in the future will assess the manner of characterization which the parties have chosen does not make good

business sense and prevents plans from being prudently and carefully implemented according to the agreement of the parties.

3. The lower court's decision is so clearly erroneous that it departs from customary standards in the administration of justice and calls for correction by this court. Section 162 of the Internal Revenue Code specifically permits a deduction "for salaries or other compensation for personal services actually rendered." At the time of his termination of employment with American, Levitt had only received a salary of $8,600 for approximately nine and one-half months of part and full-time work. During the same time period, American showed current estimated profits in excess of $100,000 solely as a result of Levitt's services. Clearly, a

salary amount not commensurate with the positions of responsibilities and the value of his services. It should also be noted that high compensation is more reasonable when as in the present case there is a corresponding lack of fringe benefits, such as, pension plans or stock options, which might normally be expected.[4] Where the personal efforts of the major stockholder in a closely held corporation are responsible for its success, the law has long recognized that a larger salary for such person is appropriate.[5] The principal rule that pervades these cases emphasize that if

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[4]Cherokee Warehouses, Inc. v. Commissioner, 82-1 USTC para. 9186, 6th Cir.

[5]Gordy Tire Co. v. U.S., 296 F.2d 476 (Ct. Cl. 1961).

sales and profits are higher as the result of the time and efforts of an employee, a higher compensation is justified.

In the instant case, there can be no question but the valuable services were rendered by Levitt which justify the commission payments made to him under the terms of the Termination Agreement. The evidence unquestionably supports a finding that the transaction was bona fide and not tax motivated but entered into for other good and sufficient non-tax reasons. It was a valid business purpose for American characterizing the transaction as compensation for services rendered by Levitt. Under these circumstances, the lower court should not be permitted to rewrite the terms of the transaction and substitute

its business judgment as it has done in its opinion.

4. The inconsistent position taken by the Commissioner of Internal Revenue in the present case enables the Treasury to be unfairly and unjustly enriched. The decision of the lower court encourages the Commissioner to raise additional revenue by adopting inconsistent positions with respect to one party in a transaction or agreement similar to the one in this case without joining the other party to the litigation. In the present case, both parties to the Termination Agreement reported the transaction consistently on their respective tax returns. Levitt reported the $50,000 payment in 1975 on his federal income tax return as commissions subject to the maximum fifty percent income tax

rate on earned income while American deducted the payment of its 1975 corporate income tax return. The Treasury received the income taxes on the transaction from Levitt reporting the payment as income on his tax return. Now as a result of the affirmation of the Tax Court's decision by the Third Circuit Court of Appeals, it will again receive revenue from the same transaction but a different source, as a result of the Commissioner successfully arguing American's deduction was totally improper and represented a non-deductible redemption of stock.

If the Third Circuit prevents a taxpayer from using the tax laws to avoid the tax consequences of his agreement by taking an inconsistent position,[6] it

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[6] Danielson v. Commissioner (1967) 67-1 USTC para. 9423; 378 F.2d 771.

should treat all litigants equally and preclude the Commissioner from adopting inconsistent positions in cases like the present one. The rationale of the Danielson decision, supra, was to discourage taxpayers to litigate an allocation or characterization of a transaction, which was agreed to, by adopting an inconsistent position for tax purposes resulting in a loss of revenue to the federal government. However, equity and reason dictate that there be a correlation to the Danielson rule, namely, that the Commissioner cannot use the tax laws to unfairly and unjustly enrich the Treasury by treating a transaction differently and inconsistently as he has done in the present case. Consistency in this area of the law should not discriminate.

5. The Government will undoubtedly contend that this writ of certiorari requests this Court to evaluate facts, which on its face violates Rule 52(a) of the Rules of Civil Procedure, 28 U.S.C.A., which provides that findings by the trial court shall not be set aside "unless clearly erroneous."

"A finding is clearly erroneous when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed."[7] However, obeisance to the "clearly erroneous rule" must yield when the facts are undisputed and the Court

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[7] United States v. Gypsum Company, et al., 333 U.S. 364, 395, 68 S. Ct. 525, 542, 92 L. Ed. 746 (1948).

is then called upon to apply reason and interpretation.[8] Therefore, since the present case hinges on the interpretation and construction of contracts and on the legal characterization for federal tax purposes of the transaction between the parties, which is not a question of fact but rather one of law,[9] the Tax Court's decision relative to this case is not to be garrisoned by the clearly erroneous rule.[10] The issues on appeal are legal rather than factual. There is

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[8] American National Bank of Austin v. United States, 5 Cir., (70-1 USTC Para. 9184) 421 F.2d 442, 451 (1970).

[9] Waterman Steamship Corporation v. Commissioner of Internal Revenue, 5 Cir., (70-2 USTC Para. 9514) 430 F.2d 1185, 1192, cert. denied 401 U.S. 939, October Term, (1970).

[10] American National Bank of Austin v. United States, supra.

no dispute as to the facts as found by the Tax Court.

In a case concerning capital gain versus ordinary income arising out of the sale of subdivided real estate,[11] a Court of Appeals reversed a judgment of the District Court in favor of the taxpayer, saying that in the instant case the Trial Court found the basic facts which there was no disagreement, from which it concluded the ultimate fact that the holding was not primarily for sale in the ordinary course of the taxpayer's business. In weighing the arguments on this point, the Appeals Court recognized that the characterization of the taxpayer's manner of holding the

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[11] United States v. Winthrop, (1969, C.A. 5 Fla) 417 F.2d 905.

lands was a question of fact, but said that the District Court's finding on this ultimate issue is not to be garrisoned by the "clearly erroneous" rule. Though it has factual underpinnings, the Court points out, this ultimate issue is inherently a question of law and obedience to the "clearly erroneous" rule must yield when the facts are undisputed and an appellate court is called upon to reason and interpret; this is the law obligation of the Court as distinguished from its fact finding duties, and where the conclusion of the trial court as to an ultimate fact is merely a product of legal reasoning, that the conclusion is subject to appellate review free from the restraint of the "clearly erroneous" rule.

It should be noted also that to the extent there may be disagreements with respect to the inferences to be drawn therefrom, or with respect to "ultimate facts, the Third Circuit has ruled that the "clearly erroneous" standard is not applicable.[12]

In the present case, there was no dispute that Levitt performed services for American resulting in profits of in excess of $100,000 for the company. The lower court recognizes these services not to support or justify the $50,000 payment as compensation under the Termination Agreement but rather as a payment in

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[12] Soles v. Franzblau, 352 F.2d 47 (3d Cir. 1965), cert. denied, 383 U.S. 911 (1966); Kuhn v. Princess Lida of Thurn & Taxis, 119 F.2d 704 (3d Cir. 1941).

redemption of Levitt's fifty percent stock interest in American.

## CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

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No. 82-3410

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AMERICAN INTERNATIONAL COAL CO., INC.

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

(Tax Court Docket No. 14574-79)

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Submitted Under Third Circuit Rule 12(6)

March 7, 1983

BEFORE: SEITZ, Chief Judge, HIGGINBOTHAM and SLOVITER, Circuit Judges.

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JUDGMENT ORDER

After consideration of the contentions raised by appellant and essentially for the reasons appearing in the opinion of the Tax Court (Tax Ct. Memo. Dec.

(P-H) para. 82,204) and our conclusion that the decision is supported by substantial evidenc, it is

ADJUDGED AND ORDERED that the decision of the Tax Court be and is hereby affirmed.

Costs taxed against appellant.

By the Court,

/s/ Seitz
Chief Judge

ATTEST:

/s/ Sally Mrvos
Sally Mrvos, Clerk

DATED: March 8, 1983

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 82-3410

AMERICAN INTERNATIONAL COAL CO., INC.,

Appellant

v.

COMMISSIONER OF INTERNAL REVENUE

(TAX COURT DOCKET NO. 14547-79)

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SUR PETITION FOR REHEARING

PRESENT: SEITZ, Chief Judge, ADAMS, GIBBONS, HUNTER, WEIS, HIGGINBOTHAM, SLOVITER, BECKER, District Judges.

The petition for rehearing filed by Appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for

rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

By the Court,

/s/ Seitz
Collins J. Seitz
Chief Judge

Dated: March 31, 1983

TERMINATION AGREEMENT

THIS AGREEMENT, made this 3rd day of October, 1975, by and between RICHARD M. HANDLER, 1097A Fountain Lane, Columbus Ohio 43213, true and lawful attorney for STEPHEN C. LEVITT, formerly of 582 Clemson Drive, Mt. Lebanon, Pennsylvania, hereinafter referred to as "Employee,"

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AMERICAN INTERNATIONAL COAL CO., INC., a Pennsylvania corporation, hereinafter referred to as "Employer."

W I T N E S S E T H:

WHEREAS, Employee has been previously employed by Employer as President, General Manager and Sales Representation; and,

WHEREAS, Employer has been engaged in the business of coal brokering; and

WHEREAS, Employee has consummated various sales of coal on behalf of Employer which have resulted in earnings and profit to Employer; and

WHEREAS, Employee is entitled to commissions on said sales as set forth herein and is terminating his employment with Employer as of the 3rd day of October, 1975;

NOW, THEREFORE, intending to be legally bound hereby, the parties agree as follows:

1. On or before the 3rd day of October, 1975, Employer shall pay to Employee the sum of FIFTY THOUSAND ($50,000.00) DOLLARS in cash, certified or cashier's fund, which said sum shall be in partial payment of commissions due Employee for services rendered to Employer.

2. In addition to the sum of FIFTY THOUSAND ($50,000.00) DOLLARS as set forth in Paragraph 1, Employer shall pay to Employee the sum of TWELVE THOUSAND ($12,000.00) DOLLARS payable at the rate of TWO HUNDRED ($200.00) DOLLARS per week for each and every week, commencing on the week beginning Monday, October 6, 1975, without interest on unpaid principle balance due.

3. Employee agrees to accept the sum set forth in Paragraphs 1 and 2 as full and complete satisfaction of any and all amounts due to him from Employer for services rendered in connection with Employer's coal brokerage business.

4. RICHARD M. HANDLER covenants and warrants that he has full and complete right, power and authority to enter into the agreement set forth herein

pursuant to that certain Power of Attorney which is attached hereto as Exhibit "A".

5. The provisions of this agreement shall insure to the benefit of and by the successors and assigns of Employer and Employee and the executors, administrators, heirs, successors and assigns of all parties herein.

IN WITNESS WHEREOF, the parties have hereunto affixed their hands and seals the day and year first above written.

WITNESS: STEPHEN C. LEVITT

/s/Robert J. Cindrich by: /s/Richard M. Handler
Richard M. Handler

ATTEST: AMERICAN INTERNATIONAL COAL CO., INC.

/s/Richard C. Schomaker /s/Richard C. Schomaker
Secretary Richard C. Schomaker

AGREEMENT

THIS AGREEMENT made this 5th day of December, 1974, by STEPHEN LEVITT, ROBERT L. TODD, and RICHARD C. SCHOMAKER.

WHEREAS, the parties hereto desire to enter the coal mining and brokering business; and

WHEREAS, each of the parties hereto has already contributed important talents, business connections and efforts to various coal transactions;

NOW, THEREFORE, the parties hereto mutually covenant and agree as follows:

1. The parties hereto hereby agree to form the AMERICAN INTERNATIONAL COAL COMPANY, INC., a corporation, and/or any other appropriate entity or entities for the purposes of conducting a coal business, including coal mining and coal brokering.

2. Each party covenants to contribute all business contacts, contracts and any and all rights pertaining to coal to the corporation. However, the contracts previously arranged by Todd between Freehold Land and Mineral Company and the GCU and between Freehold Land and Mineral Company and the Eutsey Estate are excluded; all rights accruing to Todd under the aforementioned two contracts shall belong to Todd individually.

3. If any party to this Agreement performs services in excess of those services rendered by the other shareholders, he shall be compensated on a reasonable basis in addition to his proportion of the net profits.

4. All net profits, after expenses, shall be divided equally among the shareholders.

5. It shall be a prerequisite to this agreement that each shareholder enter either a post-nuptial or pre-nuptial agreement, whichever shall be appropriate, to the effect that the present wife or prospective spouse of the shareholder shall not be entitled to any interest in the corporation.

6. All business decisions of the corporation shall be made by a majority of the shareholders, all of whom shall be entitled to vote.

IN WITNESS WHEREOF, and intending to be legally bound, the parties hereto have executed this Preincorporation Agreement the day and year first above written.

WITNESS:

/s/Jane Green Davis — /s/Stephen C. Levitt (SEAL)
STEPHEN LEVITT

/s/Jane Green Davis — /s/Robert L. Todd (SEAL)
ROBERT L. TODD

/s/Jane Green Davis — /s/Richard C. Schomaker (SEAL)
RICHARD C. SCHOMAKER

# AGREEMENT OF SALE

THIS AGREEMENT, made this 3rd day of October, 1975, by and between RICHARD M. HANDLER, 1097A Fountain Lane, Columbus Ohio 43213, true and lawful attorney for STEPHEN C. LEVITT, formerly of 582 Clemson Drive, Mt. Lebanon, Pittsburgh, Pennsylvania, hereinafter referred to as "Seller",

A
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D

AMERICAN INTERNATIONAL COAL CO., INC., a Pennsylvania corporation, hereinafter referred to as "Buyer."

W I T N E S S E T H:

WHEREAS, Buyer desires to purchase all of the outstanding common capital stock of AMERICAN INTERNATIONAL COAL CO., INC., owned by Seller; and

WHEREAS, Seller desires to sell and dispose of his stock in the said corporation at the price and on the terms hereinafter set forth; and

WHEREAS, STEPHEN C. LEVITT is the record owner of 1000 shares of common capital stock of AMERICAN INTERNATIONAL COAL CO., INC.; and

WHEREAS, by instrument dated September 26, 1975, a copy of which is attached hereto, designated Exhibit "A" and made a part hereof, and therein granted RICHARD M. HANDLER the power to sell, assign, transfer and dispose of any and all stock owned by STEPHEN C. LEVITT:

NOW, THEREFORE, intending to be legally bound hereby, the parties agree as follows:

1. Seller agrees to sell to Buyer and Buyer agrees to purchase from Seller

1000 shares of the common capital stock of AMERICAN INTERNATIONAL COAL CO., INC., a Pennsylvania corporation, at the price and upon the terms and conditions hereinafter set forth.

2. PURCHASE PRICE. The purchase price to be paid by Buyer to Seller for the said 1000 shares of common capital stock of AMERICAN INTERNATIONAL COAL CO., INC. shall be ONE THOUSAND ($1,000.00) DOLLARS, payable as set forth below:

A. On the date of closing as set forth hereinafter, Buyer shall surrender to Seller, Seller's promissory judgment note dated the 22nd day of December, 1974, in the amount of ONE THOUSAND ($1,000.00) DOLLARS marked cancelled and paid in full and Seller shall be relieved from any further responsibility to make payments of principle or interest on account of said note.

3. The delivery to Buyer of certificates for the shares of common capital stock sold hereunder by Seller and the payment of the purchase price as set forth above shall take place at the offices of the corporation on the 3rd day of October, 1975.

4. On said closing date, Seller shall deliver to Buyer the certificate evidencing the 1000 shares of common capital stock of AMERICAN INTERNATIONAL COAL CO., INC., agreed to be sold hereunder, duly endorsed for transfer.

5. WARRANTIES AND REPRESENTATIONS OF SELLER. Seller hereby warrants, represents and agrees to and with Buyer as follows:

A. Seller has full, complete and absolute title to the shares of stock to be transferred hereunder;

B. RICHARD M. HANDLER covenants and warrants that he has full and complete right, power and authority to make the sale and conveyance contemplated hereunder pursuant to that certain Power of Attorney which is attached hereto as Exhibit "A";

C. The title of the Seller to the said shares is free and clear of any lien, charge, or encumbrance and said shares, aggregating 1000 shares, constitute Fifty (50%) percent of all of the outstanding capital stock of the corporation, and by sale of said shares of stock hereunder, Buyer will receive good and absolute title thereto, free of any liens, charges or encumbrances thereon;

D. AMERICAN INTERNATIONAL COAL CO., INC., is a corporation duly organized and existing under and by virtue of

the laws of the Commonwealth of Pennsylvania and is in good standing under the laws of that state; said outstanding 1000 shares of capital stock of said corporation have heretofore duly been issued; all of said issued and outstanding shares are valid, fully paid and nonassessable, and no assessment is outstanding against the same or any part thereof; and, that all stock transfer restrictions affecting the transfer of said shares of capital stock to Buyer hereunder have been duly complied with or effectively waived by this Agreement, and that upon the closing hereunder, Buyer will have full and absolute title to said shares, free and clear of all liens, charges or encumbrances.

E. STEPHEN C. LEVITT, by his true and lawful attorney, RICHARD M. HANDLER, shall cause to be delivered to

Buyer, his written resignation as officer and director of the corporation;

F. The warranties, representations and agreements set forth herein shall be continuous and shall survive the delivery by Seller and the receipt by Buyer of the capital stock to be sold hereunder.

6. Seller hereby waives all preemptive rights and restrictions on the sale and transfer of the capital stock sold hereunder and agrees to hold Buyer harmless from and against all liability, loss, damage, or claims arising directly or indirectly from Buyer's failure to obtain hereunder absolute, entire and unconditional ownership of the capital stock of the corporation, free and clear of all restrictions. liens, charges or encumbrances.

7. The provisions of this Agreement shall inure to the benefit of and bind the successor and assigns of Seller and Buyer and the executors, administrators, heirs, successors and assigns of all parties herein.

IN WITNESS WHEREOF, the parties have hereunto affixed their hands and seals the day and year first above written.

WITNESS: STEPHEN C. LEVITT

_____ by: /s/Richard M. Handler
Richard M. Handler

ATTEST: AMERICAN INTERNATIONAL COAL CO., INC.

/s/Richard C. Schomaker
Secretary

by: /s/Richard C. Schomaker
President

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SEP 6 1983

ALEXANDER L. STEVAS, CLERK

No. 82-

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1982

American International Coal Co., Inc., Petitioner,

v.

Commissioner of Internal Revenue, Respondent.

**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT**

Supplemental Appendix

Roy J. Roscoe
400 Manordale Road
Pittsburgh, PA 15241
(412) 835-7346
Counsel for the Petitioner

SUPPLEMENTAL APPENDIX

U.S. Tax Court Written Opinion

T. C. Memo. 1982-204

UNITED STATES TAX COURT

AMERICAN INTERNATIONAL COAL CO., INC.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

Docket No. 14574-79 Filed:
April 15, 1982

Roy J. Roscoe, for the petitioner.

Edward F. Peduzzi, Jr., for the
respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

FEATHERSTON, Judge: Respondent determined a deficiency in the amount of $21,975.87 in petitioner's Federal income tax for 1975. The sole issue[1] for decision is whether petitioner, a corporation, paid Stephen C. Levitt, an employee and shareholder, $54,800 as deductible compensation for services or as a nondeductible distribution in redemption of his stock.

FINDINGS OF FACT

Petitioner, American International Coal Co., Inc., had its principal office in Pittsburgh, Pennsylvania, when the

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[1] At the trial petitioner conceded an issue with respect to a claimed theft loss in the amount of $4,025. Petitioner has apparently abandoned a request for attorney fees made in the petition.

petition was filed. Petitioner filed its Federal income tax return for 1975 with the Philadelphia Service Center.

On December 5, 1974, Robert L. Todd (Todd), Stephen C. Levitt (Levitt), and Richard C. Schomaker (Schomaker) entered into a preincorporation agreement in which they agreed to form a corporation to be known as American International Coal Company, Inc., to conduct a coal mining and brokering business. Each party was to contribute to the corporation "all business contacts, contracts and any and all rights pertaining to coal" excepting two coal contracts specifically reserved by Todd. Article 3 of the agreement provided that:

> If any party to the Agreement performs services in excess of those services rendered by the other shareholders, he shall be compensated on a reasonable

basis in addition to his proportion of the net profits.

As to the division of net profits, Article 4 of the agreement provided that: "All net profits, after expenses, shall be divided equally among the shareholders." All business decisions were to be made by a majority vote of the shareholders.

Of the three incorporators, Todd was the only one with previous experience in the coal business. He arranged for operating capital and he was expected to handle activities in the coal fields. Levitt was to be responsible for day-to-day operations, and Schomaker was to serve as legal counsel. Levitt and Schomaker as cosigners were authorized to write checks for the business from a checking account opened by Levitt.

After petitioner's incorporation on

December 24, 1974, the preincorporation agreement was ratified by the corporation in all respects except as to Todd. Because Todd was believed to have misapplied some funds, he was not permitted to become an officer or shareholder, but he served as a "probationary employee" until March or April 1975. Levitt and Schomaker became the original and only shareholders, each owning 50 percent (1,000 shares each) of the stock.

Levitt devoted much of his time to the work of the corporation from the outset. Beginning May 1, 1975, he became a full-time employee of petitioner with an office in his home, receiving a salary of $400 per week plus the use of a car and hospitalization insurance. The salary received by Levitt during 1975 totaled $8,600. For his legal

services to petitioner, Schomaker received $1,800 prior to September 23, 1975, and $5,600 for the remainder of the year, a total of $7,400.

During 1975, the first year of its operations, petitioner was engaged only in the business of supplying coal under contract, i.e., the brokering of coal. Petitioner neither owned nor operated any coal mining or coal processing facilities but bought for resale coal mined by others. During the period January 1975 to March 1, 1975, petitioner procured three contracts to ship coal as follows: (1) A contract with West Penn Power Company (West Penn) for its Hatfield Ferry Power Station; (2) a "contract" with H. J. Heinz Company to ship on a purchase order basis; and (3) a contract with United States Steel Cor-

poration. All of these contracts expired on or before August 30, 1975.

On March 20, 1975, petitioner entered into a contract with West Penn to supply its Armstrong Power Station with approximately 20,000 tons of coal per month, during the period beginning April 1, 1975, and ending December 31, 1978. Petitioner was to receive a base price of 92.5 cents per million Btu for coal having a base heating value of 12,000 Btu per pound. Clause 6 of the contract provided that, on or before November 1, during each year of the contract, negotiations could be had for base price adjustments or for termination of the contract.

Prior to the execution of this West Penn contract, Todd advised Levitt and Schomaker that West Penn planned to

let long-term contracts for coal. In order to obtain a coal supply for such a contract, Levitt negotiated a deal with Shaw Coal Company (Shaw) to supply a quantity of coal equal to the amount ultimately called for in the West Penn contract. The agreement with Shaw was, in effect, a duplicate of petitioner's contract with West Penn except for changes in the designation of the parties and a 10-cent reduction in the base price. Without the arrangements for a supply of coal from Shaw, West Penn most likely would not have awarded the contract to petitioner, and petitioner would not have committed itself on a supply contract of such magnitude.

Shortly after the West Penn contract became effective, Shaw defaulted on its agreement and stopped delivering

coal to petitioner. Levitt then entered the spot market for coal and obtained sufficient tonnage on open-ended purchase orders to enable petitioner to meet its contract commitment to West Penn. Although the spot market purchase arrangement caused petitioner's brokerage business to take larger risks, Levitt was successful in establishing a good working relationship with several suppliers. In fact, buying coal from these suppliers and reselling it to West Penn was proving more profitable than the arrangement would have been under the Shaw contract.

Levitt believed that the company was going to grow and increase in profitability. Petitioner's business was doing well under Levitt's management until September 23, 1975. On that date,

without an opportunity for Schomaker to make arrangements for someone to succeed Levitt, Levitt was taken into protective custody under the Federal witness protection program.

Levitt had no prior warning that he would be required to enter Federal custody. He spent September 24, 1975, making arrangements to sell his property and terminate his business affairs. Without a balance sheet, profit and loss statement, or an audit of petitioner's financial situation, Levitt concluded on a review of the receivables, payables, and cash in the checking account that the corporation at that time had a "plus" position of something over $100,000. In other words, if petitioner had paid all its bills and collected all the money due to it at the time, petitioner would

have been ahead approximately $100,000. As a result of this examination of the books, he decided that he "wanted $50,000" for his interest in the company. In making his computations, he did not take into account a liability to Page Coal Company on a $24,000 judgment note and did not consider the Federal tax liability of petitioner.

Levitt prepared a check (No. 1364) dated September 24, 1975, payable to himself and drawn on petitioner's account in the amount of $50,000 which, to be negotiable, required Schomaker's counter signature. On the check stub, he placed the words "For the purchase of of the stock of Stephen C. Levitt." On behalf of Levitt, a messenger presented the check to Schomaker for his counter-signature on September 25, 1975.

Schomaker refused to sign it at that time.

On September 25, 1975, Levitt, through agents of the Federal Bureau of Investigation, retained Robert J. Cindrich (Cindrich), an attorney to represent him in handling his civil affairs. Levitt reviewed his financial affairs with Cindrich, including the need to terminate his interest in petitioner. Later, Levitt and Schomaker had a brief private meeting during which Schomaker advised Levitt that he could not sign the $50,000 check "the way it was." It was agreed that Cindrich would conclude the negotiations for terminating Levitt's interest in petitioner. On Cindrich's recommendation Levitt gave his brother-in-law, Richard M. Handler (Handler), a general

power of attorney authorizing him to (among other things) sell Levitt's real estate, stocks, bonds, and other property.

Levitt left the City of Pittsburgh in the protective custody of the United States Department of Justice on the night of September 25, 1975. Subsequently, Cindrich and Schomaker met to discuss the termination of Levitt's interest in petitioner. Before this meeting was held, Schomaker examined petitioner's books and concluded that petitioner's net profits exceeded $70,000 without regard to the judgment note held by Page Coal Company. Schomaker offered to make a payment to Levitt which would for the most part be characterized as a "commission" rather than as a payment for stock. Cindrich did not attempt to

negotiate the point, but simply communicated the offer to Levitt who expressed satisfaction with it even though Cindrich advised him that the payment was to be reported for tax purposes as ordinary income. Subsequently, Cindrich drafted two documents, one entitled "Termination Agreement" and the other "Agreement of Sale."

The Termination Agreement, dated October 3, 1975, describes Levitt as "Employee" and petitioner as "Employer," and it recites that "Employee is entitled to commissions" on "various sales of coal on behalf of Employer which have resulted in earnings and profit to Employer." The Termination Agreement provides:

> 1. On or before the 3rd day of October, 1975, Employer shall pay to Employee the sum of Fifty Thousand Dollars

($50,000.00) in cash, certified or cashier's fund, which said sum shall be in partial payment of commissions due Employee for services rendered to Employer.

2. In addition to the sum of Fifty Thousand Dollars ($50,000.00) as set forth in Paragraph 1, Employer shall pay to Employee the sum of Twelve Thousand Dollars ($12,000.00) payable at the rate of Two Hundred Dollars ($200.00) per week for each and every week, commencing on the week beginning Monday, October 6, 1975, without interest on unpaid principle (sic) balance due.

3. Employee agrees to accept the sum set forth in Paragraphs 1 and 2 as full and complete satisfaction of any and all amounts due to him from Employer for services rendered in connection with Employer's coal brokerage business.

The Agreement of Sale, by its terms, provided that Levitt agreed to sell to petitioner 1,000 shares of the common capital stock of petitioner in consideration of $1,000 ($1.00 per share).

The purchase price was to be paid by petitioner's cancellation of a $1,000 promissory note signed by Levitt in petitioner's favor upon the distribution to Levitt of the initial capital stock.

On October 3, 1975, these two agreements were signed by Schomaker on behalf of petitioner and by Handler on behalf of Levitt. On or about that same day, Schomaker countersigned the $50,000 check (No. 1364). When he countersigned it, he changed the notation on the check stub by crossing out the words "For the purchase of the stock of Stephen C. Levitt" and substituting the word "Commissions." In addition, Schomaker crossed out the original entry in petitioner's check register for check No. 1364 under a column headed "In payment of" in which Levitt had

entered "Purchase of stock," and he inserted the word "Commissions." He then delivered the check to Cindrich for transmittal to Levitt.

After Levitt's departure, Schomaker all but abandoned his law practice and devoted most of his time to the conduct of petitioner's business. On November 1, 1975, Schomaker decided to continue the West Penn contract without attempting to negotiate a price adjustment. Sometime after November 1, 1975, petitioner employed Jack Sedlack (Sedlack), who had some background in the coal business, to assist in managing petitioner's business operations. Schomaker and Sedlack were able to obtain a supply of coal sufficient to enable petitioner to continue to service the West Penn contract.

Between October 3, 1975, and December 31, 1975, Schomaker and Levitt had several conversations, some by telephone and at least one in person. In these conversations, they discussed various problems facing petitioner, including that of maintaining its coal supply. Levitt also wrote several letters to Schomaker concerning various business matters related to petitioner.

Beginning in October, 1975, petitioner paid Levitt $1,600 per month for 3 months, a total of $4,800, plus the $50,000 check. On its income tax return for 1975, petitioner deducted the total payment of $54,800 to Levitt as commissions. In the notice of deficiency issued to petitioner, respondent disallowed the deduction.

The notice of deficiency reflects

that for 1975 petitioner had taxable income as revised by respondent in the amount of $80,824.54. This figure takes into account the denial of the $54,800 deduction here in dispute as well as a deduction of a theft loss in the amount of $4,025, conceded by petitioner in this case.

On petitioner's Pennsylvania Corporation Income Tax Return for 1975, the stated value of petitioner's common stock for purposes of the Pennsylvania capital stock tax was $20,000. Petitioner's Federal income tax returns for 1976, 1977, and 1978 show net profits from its coal business totaling well in excess of $1 million for that 3-year period.

## OPINION

The issue to be decided is the

deductibility of the $54,800 that petitioner paid to Levitt during the period in 1975 following Levitt's departure from Pittsburgh. Petitioner argues that this amount was paid pursuant to the October 3, 1975, Termination Agreement as compensation for past services and for current and future consultation services for which it is entitled to a deduction under Section 162(a)(1).[2] Respondent, however,

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[2]All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In General.--There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including--

(1) a reasonable allowance for salaries or other compensation for personal services actually rendered;

maintains that the Termination Agreement is a facade to cloak a tax avoidance scheme whereby petitioner seeks a deduction from ordinary income for amounts paid to redeem Levitt's stock.

If the $54,800 in issue was, indeed, compensation for services, it would be deductible by petitioner, as it contends, and would be taxable to Levitt as ordinary income.[3] On the other hand, if it was paid to redeem Levitt's stock in petitioner, the payment would not be deductible by petitioner and would be taxable to Levitt as capital gain. These countervailing tax interests of the parties in the ordinary case would tend to deter artificial arrangements. Cf.

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[3]Levitt's tax liability is not in issue here.

Schulz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), affg. 34 T.C. 235 (1960); Ullman v. Commissioner, 264 F.2d 305, 307 (2d Cir. 1959), affg. 29 T.C. 129 (1957). But it is an elementary rule of tax law that in proper cases the Commissioner may look beyond the formal documents and assert taxability upon the substance and reality of the transaction. Higgins v. Smith, 308 U.S. 473 (1940); Griffiths v. Commissioner, 308 U.S. 355 (1939). That is what respondent maintains he has done here.

The issue presented is factual. In the light of the entire record, we conclude that $50,000 of the agreed $62,000 payment was paid to redeem Levitt's stock. As to the remaining $12,000, only $4,800 of which was paid in 1975, the issue is close, but on the record before

us we hold that is was paid as compensation for consultation services.

1. The $50,000 Check

To support its theory that the entire $62,000 payment was to be made for Levitt's services, petitioner relies upon the Termination Agreement, quoted in part in our findings, which describes the payments therein provided as "commissions" due Levitt "for services rendered." By the terms of this agreement, Levitt agreed to accept a total of $62,000 "as full and complete satisfaction of any and all amounts due to him" from petitioner "for services rendered" in petitioner's coal brokerage business. This agreement, petitioner argues, gains economic substance from the preincorporation agreement of December 5, 1974, which provided that, if

one shareholder performed services in "excess" of those services rendered by the other shareholders, he would be "compensated on a reasonable basis in addition to his proportion of the net profits."

Petitioner points out that Levitt devoted at least a substantial amount of his time to petitioner's business from January 1, to May 1, 1975, and devoted his full-time from May 1, 1975, to the date of his departure from Pittsburgh on September 25, 1975, receiving total compensation of only $8,600. In the meantime, Schomaker, the other shareholder, served as petitioner's attorney and received a total amount of $1,800 for his services while continuing his law practice prior to September 24, 1975.

As evidence of Levitt's valuable services prior to his departure, petitioner maintains that Levitt, through his efforts and work, was "solely responsible for the success of American's (petitioner's) profits in excess of $70,000 or $100,000." Petitioner also emphasizes Levitt's role in obtaining the West Penn contract which provided for potential coal sales of approximately $20,000,000. To obtain coal to service this contract, Levitt had initially contracted with Shaw and, when Shaw failed to perform satisfactorily, he had arranged for coal on open-ended purchase orders with several suppliers. This purchase order arrangement was working well on September 23, 1975, when Levitt entered the protective custody of the U.S. Department of Justice.

Many of the facts cited by petitioner to show the value of Levitt's services, however, tend also to show that petitioner's stock had substantial value when Levitt left Pittsburgh, and they indicate that most (if not all) of the payment called for in the Termination Agreement was, in fact, paid to redeem his stock. As of September 23, 1975, petitioner had a going brokerage business with assets which included the West Penn contract and arrangements with at least six suppliers who, in 1975, had abundant quantities of coal available to enable petitioner to service that contract. From the approximately $20,000,000 in sales reasonably expected to be made under the contract, Levitt testified that, if things went well, he had "figured" petitioner "should have" a

gross profit (before taxes, operating expenses, and overhead) of $1,000,000 on the basis of a "pretty standard" 5-percent commission "in the coal business."

Levitt's presence was not essential to the continued viability of the West Penn contract, the source of most of petitioner's income. This going-concern value--"the ability of a business to continue to function and generate income without interruption as a consequence of the change in ownership," VGS Corp. v. Commissioner, 68 T.C. 563, 592 (1977); Computing & Software, Inc. v. Commissioner, 64 T.C. 223, 235 (1975)--shows that the business, which had netted $70,000 to $100,000 in 9 months, had substantial value. It demonstrates that the cancellation of Levitt's $1,000 note,

purportedly in redemption of Levitt's stock, had little relationship to the stock's value.[4] True, with Levitt's abrupt departure, the business would require prompt attention by some other full-time manager, but the subsequent success enjoyed by Schomaker, assisted by Sedlack, in managing the business demonstrates that the problem was not

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[4]Levitt testified that the West Penn "contract had a value because it could be sold" and that in his opinion "that contract could be taken to any coal broker in the country and sold on a percentage basis." By its terms the contract was not assignable, without West Penn's consent, but Levitt indicated that even though the contract "may say that" the nonassignment provision would not prevent the sale of coal to West Penn through other brokers on a percentage basis.

insurmountable.[5]

Petitioner would have us treat the preincorporation agreement as if it were a contingent compensation agreement of

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[5]On petitioner's Pennsylvania Corporation Income Tax Return for 1975, the stated value of petitioner's common stock was reported to be $20,000. On its Federal income tax returns for the period covered by the West Penn contract, petitioner showed total net profits from the coal brokerage business exceeding $1,000,000. While the size of those net profits may not have been fully foreseeable, the prospects for profit were sufficient to induce Schomaker to virtually abandon his law practice and take over the management of the business; the amount of income in 1975 depends in large part upon the outcome of the instant case but, as we view the facts, was in the $70,000 to $100,000 range.

the kind described in Section 1.162-7(b)(2), Income Tax Regs.;[6] see, e.g., Lewisville Investment Co. v. Commissioner, 56 T.C. 770 (1971).

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[6]Sec. 1.162-7. Compensation for personal services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

On the basis, petitioner would have us conclude that Levitt was entitled to additional compensation for services because he had obtained the West Penn contract and devoted more time and effort than Schomaker to petitioner's business prior to September 24, 1975. We think this argument misapprehends the effect of the preincorporation agreement.

Significantly, the preincorporation agreement was originally drafted as a "Preliminary Limited Partnership Agreement" between Levitt, Todd, and Schomaker and was then modified by pen and ink changes to a "Pre-Incorporation Agreement." In addition to providing for a shareholder to be compensated on a reasonable basis for services in excess of the services rendered by the other

shareholders, it provided for an equal division of the profits and for all business decisions to be made "by a majority of the shareholders (including Todd), all of whom shall be entitled to vote." It thus implicitly provided for an equal three-way division of the corporation's stock.

Because Levitt and Schomaker concluded that Todd had improperly used business funds prior to the issuance of the stock, Todd was denied any stock in the corporation and, apparently, on that ground was denied the right to participate in business decisions to share in post-incorporation profits, or to be paid for preincorporation services in excess of the services of the other shareholders. There is not evidence to indicate in what other respects the

preincorporation agreement was modified as between Levitt and Schomaker when Todd was frozen out. While there is testimony, and we have found, that the agreement was ratified and approved by the corporation except as to Todd, the record does not show on what terms. But even if the agreement did survive, we think it was not a continuing contingent compensation agreement. It was merely an agreement that each shareholder would be paid reasonable compensation for his "excess" services in initiating the business.

Further, as we view the evidence, reliance on the preincorporation agreement to explain the Termination Agreement is an afterthought. The Termination Agreement makes no reference, in the words of the preincorporation agreement, to "services in excess of

those services rendered by the other shareholders." The preamble of the Termination Agreement[7] recites that

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[7]The preamble of the Termination Agreement is as follows:

WHEREAS, Employee (Levitt) has been previously employed by Employer (petitioner) as President, General Manager and Sales Representation; and,

WHEREAS, Employer (petitioner) has been engaged in the business of coal brokering; and

WHEREAS, Employee (Levitt) has consummated various sales of coal on behalf of Employer (petitioner) which have resulted in earnings and profit to Employer (petitioner); and

WHEREAS, Employee (Levitt) is entitled to commissions on said sales as set forth herein and is terminating his employment with Employer (petitioner) as of the 3rd day of October, 1975;

Levitt had "consummated various sales of coal" on behalf of petitioner "which have resulted in earnings and profit" to petitioner and that Levitt is "entitled to commissions on said sales." Consistent with these recitations, the check payable to Levitt and the entry in the check registry written by Levitt when he prepared the $50,000 check were modified by Schomaker when he countersigned the check to indicate the payment was made for "commissions." The preincorporation agreement makes no reference to commissions. None of petitioner's actions at the time of the settlement with Levitt appear to have been taken on the theory that he was entitled under the preincorporation agreement to additional compensation for services in excess of the services

performed by the other shareholders.

When Levitt found out that he was going to be forced to leave Pittsburgh, moreover, he examined petitioner's books and concluded that "the company was in a plus position in excess of $100,000" if it paid all the bills and collected its receivables. On that basis, he decided that he "wanted $50,000 for ***(his) interest in the company" and that $50,000 would be fair" for his interest.[8]

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[8]Schomaker testified that he "analyzed the books as of the end of September, 1975" and "determined that there was approximately $70,000 that was left over after taking into account receivables, payables, paid payables and paid receivables." The reason for the difference between the two figures is not clear. Levitt explained that his $100,000 figure was not a precise one but, taking that approximate figure into account, $50,000 would be fair for his interest.

To that end, at a time when he was effectively sealed off from outside contracts with anyone, Levitt prepared and signed a $50,000 check (which required Schomaker's countersignature) payable to himself, writing on its face that it was for the "purchase of stock" and making corresponding entries in petitioner's books.[9] That same

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[9]At one point Levitt testified:

Q. ***Did you view it (the $50,000 he claimed) more as a division of profits rather than salary?

A. Yes, because that's where I came up with the $50,000.

Q. Did you make any further claim for salary other than what you made?

A. I did not.

check was ultimately countersigned by Schomaker and delivered to Levitt, altered on its face only to show that it was for "commissions" rather than for the purchase of his stock.

From May 1, 1975, to September 24, 1975, Levitt was a full-time employee receiving as compensation a salary of $400 per week, use of a car, and a hospitalization insurance policy. Levitt made no claim for any additional compensation for past services at any time. In fact, he testified that he felt that he "had been compensated fairly up to that point." He further testified that if he had stayed with the company he anticipated that "we would take the profits that were left in the company and I would get my share and he (Schomaker) would get his

share" at the end of 1975.[10]

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[10]Levitt testified:

Q. So having arrived at no further agreement for extra compensation, did you at this point feel that you were entitled to extra compensation?

A. I felt that my position in the company was worth $50,000 to me.

Q. And you had been compensated fairly up until that point.

A. Right. In other words, there were profits in the company, and I felt I was getting $400 a week plus a car plus insurance, and Rick (Schomaker) was doing his bit with the law and getting paid for that, and at the end of the year we would take the profits that were left in the company and I would get my share and he would get his share.

Q. If you had remained with the company and all these terrible events hadn't happened and you had to leave town, would you have negotiated for extra salary for the year 1975?

A. No, not in 1975, I don't think so.

Q. As far as you were concerned, you wanted $50,000 and that came out of profits, right?

Petitioner would have us discount this testimony because, he argues, Levitt initially took the position that he should be paid $50,000 for his stock rather than additional compensation only to obtain the more favorable capital gain treatment of his receipts. We think it quite inconceivable that Levitt gave tax consequences any real consideration at a time when he was abruptly taken into Federal custody and was faced with having himself and his family uprooted and removed to some other city where they would take a new identity and start life all over again. We think he was truthful when he testified that, as to

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Footnote 10 -- continued

A. Yes, sir.

tax consequences, he "did not care."[11]

It is true that Levitt's attorney-in-fact, Handler, executed the Termination Agreement describing the $50,000 payment as "partial payment of commissions***for services rendered" and

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[11]Levitt testified on cross-examination by petitioner's counsel:

> Q. By characterizing the transaction as a sale of stock, you expected them to reduce the tax consequences to you; is that right?
>
> A. No, sir. When I tell you I gave no consideration to stock, I had to liquidate, and that was the farthest thing, I mean as far as tax, that was the farthest thing from my mind.
>
> Q. The tax consequences.
>
> A. Absolutely. I did not care.

See also fn. 12, infra.

the Agreement of Sale describing cancellation of the $1,000 note as consideration for the sale of his stock. It is also true that Levitt in 1979 signed a "Certification" that "all payments" received from petitioner during October 1975 and thereafter were "ordinary commissions/income subject to ordinary income tax," not in payment for his stock, and that the "actual sale of *** (his) stock was carried out by cancellation of $1,000 judgment note" against him. Levitt also signed a "Supplemental Certification" in 1980. These certifications, which were apparently signed for petitioner's use in handling this case when it was before the Internal Revenue Service, tend to discredit Levitt's testimony to some extent; but, taking into account his explanation of the circumstances in which they were

signed, they do not create serious doubts as to his testimony on the crucial facts reviewed in the foregoing discussion.

Levitt testified that when he learned he would be required to leave Pittsburgh, he was concerned about his need for cash. He retained Cindrich to represent him in closing his business affairs. Cindrich went to Levitt's home, and Levitt told him he wanted $50,000 for his interest in petitioner. After a later meeting with Schomaker, Cindrich drafted the Termination Agreement and Agreement of Sale. Cindrich testified that these agreements were not the product of any negotiations he had with Schomaker. Rather, Schomaker told him what the terms of the agreement, including the characterizations of the payments, were to be. He later

communicated the terms to Levitt, including an explanation of the income tax consequences of such characterizations, and Levitt told him he did not care whether or not the payments were characterized as ordinary income. Because Levitt knew more about the value of petitioner's business than anyone else and was "perfectly willing, so long as he could get his money to take it in that fashion," Cindrich did not attempt to negotiate the point.

Levitt testified that Cindrich explained that, in view of the terms of the Termination Agreement, he should report the payments from petitioner as ordinary income, and he did so. The certifications that he signed merely followed the terms of the Termination Agreement and reflected the manner in which he had reported the payments

from petitioner in his income tax returns. We do not think the certifications alter the facts that Levitt, who admittedly knew more about the company than anyone else, thought his interest in petitioner was worth $50,000, asked to be paid that amount, and received it. Petitioner emphasizes a long list of claims, possible claims, and potential claims against it which might have altered Levitt's approximation of its cash position, but we think the evidence shows that those possible claims were fully offset by petitioner's going-concern value, reflected in large part by the West Penn contract to which petitioner points in describing Levitt's valuable services. Moreover, the evidence shows that Schomaker did not at any time question the reasonableness of the amount

requested by Levitt, but only the characterization of that amount.

Based on a totality of the evidence, we hold that the Termination Agreement and accompanying Agreement of Sale do not reflect the substance and reality of the transaction whereby Levitt's interest in petitioner and all claims against petitioner were resolved. Petitioner gave the $50,000 check to Levitt, drafted by Levitt himself and ultimately countersigned by Schomaker, in payment for his stock. This was the price which he asked for his stock based on his knowledge of the company's assets and liabilities. This was the price he received. As a payment in redemption of his stock, the $50,000 is not deductible

by petitioner.[12]

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[12]Because of Levitt's need for immediate cash as a result of his departure from Pittsburgh, the countervailing tax considerations mentioned in the text, above, were frustrated as a means of assuring that the terms of Levitt's disposition of his interest in petitioner reflected the economic realities. As we have noted, Levitt simply "did not care" about the tax consequences of the transactions.

Levitt testified that he had received a notice of deficiency for 1975 in which respondent had not challenged his reporting of the $50,000 as ordinary income. Even if the $50,000 has been erroneously treated as compensation in computing Levitt's tax liability, we do not think, in the circumstances here presented, that such treatment alters petitioner's liability.

2. The Monthly Payments

We are left with the $12,000 payment called for by paragraph 2 of the Termination Agreement, of which $4,800 was paid in 1975.[13] At the trial respondent's counsel offered a "scenario" in which Schomaker, in order to obtain a deduction for petitioner's payment for Levitt's stock, offered to pay him $62,000 rather than the $50,000 asked by Levitt if he would agree to have the Termination Agreement describe the payment as compensation so that it would be deductible. While there is some basis for suspicion that this is what occurred, there is no evidence to support a finding to that effect. To the

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[13] Although the agreement called only for the payment of $800 per month, petitioner paid Levitt $1,600 per month.

contrary, all the testimony is that, while the additional $12,000 may have been offered in part as a magnanimous gesture, it was intended to be payment for consultation services which Schomaker needed in assuming management of the brokerage business.

After Levitt abruptly left Pittsburgh, Schomaker became responsible for petitioner's day-to-day operations but had no experience or background in handling such details. Levitt, moreover, had established oral arrangements with coal suppliers which were important to servicing the West Penn contract. Schomaker testified that, when he met with Levitt during the evening prior to Levitt's departure, he asked the Federal authorities who were at Levitt's home whether he could arrange to have Levitt,

on request, call him to advise on petitioner's business operations. He also asked whether Levitt, through proper channels, could receive and answer written inquiries. Both questions were answered affirmatively. On this basis, he agreed in writing to pay $12,000 for Levitt's consultation services. Between the time Levitt left Pittsburgh and the end of 1975, Schomaker talked by telephone with Levitt several times, met with him once in the Marshall's office in Pittsburgh, and received five letters from him. One communication, for example, involved a disputed trucking bill, and Schomaker testified that the information obtained from that communication alone saved the company $2,000.

Although Cindrich indicated that he

thought that the $12,000 provision in the Termination Agreement may have been an act of magnanimity on Schomaker's part, he did recall that Schomaker expressed a "desire for future services or future consulting on the part of Mr. Levitt." Cindrich expressly denied that there was any discussion with Schomaker to the effect that the additional $12,000 was offered in return for having the agreement designate the entire $62,000 payment as compensation. As we have previously noted, Cindrich simply did not negotiate the point.

Levitt acknowledged that he had not sought the $12,000 compensation provision and confirmed that he consulted with Schomaker on petitioner's business by telephone and by letter. He explained that he spent a great deal of time in

Pittsburgh (several days in 1975 and 6 months in 1976) in the custody of the United States Marshall (apparently to testify in pending litigation) and was permitted to talk with Schomaker by telephone. In these communications he gave Schomaker such assistance as he could.

Basing our conclusion on the whole record, we conclude that the $4,800 which petitioner paid to Levitt in 1975 pursuant to paragraph 2 of the Termination Agreement was compensation deductible under Section 162(a)(1).

To reflect the foregoing,

Decision will be entered under Rule 155.

Office-Supreme Court, U.S.
FILED
SEP 13 1983
ALEXANDER L. STEVAS,
CLERK

No. 83-59

# In the Supreme Court of the United States

OCTOBER TERM, 1983

AMERICAN INTERNATIONAL COAL CO., PETITIONER

*v.*

COMMISSIONER OF INTERNAL REVENUE

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT*

## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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*Department of Justice*
*Washington, D.C. 20530*
*(202) 633-2217*

## TABLE OF AUTHORITIES

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## MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner in this federal income tax case seeks review of the decision of the court of appeals, holding that the $50,000 petitioner paid to Stephen Levitt, an employee and shareholder, was a nondeductible distribution in redemption of his stock rather than a deductible payment for services rendered by him.

1. Petitioner is a Pennsylvania corporation engaged in the business of supplying coal under contract (C.A. App. 31).[1] The corporation was owned equally by Stephen Levitt and Richard Schomaker, each holding 1000 shares of petitioner's stock (*ibid.*). Levitt also was an employee of petitioner; his job was to negotiate coal supply contracts (*id.* at 191).

[1] "C.A. App." refers to the appendix filed with the court of appeals.

In September 1975, Levitt, for personal reasons, was required unexpectedly to terminate his relationship with petitioner (C.A. App. 197). As a consequence, Levitt reviewed petitioner's books and determined that his interest in the corporation was worth $50,000 (*id.* at 198). Accordingly, he issued himself a check in that amount, noting on the stub that the check was in payment for his stock, and arranged for the check to be presented to Schomaker for his countersignature, which was required for the check to be negotiable (*id.* at 200).

Schomaker, an attorney, objected to the statement on the check that it was payment for stock and declined to sign it (C.A. App. 200-201). Instead, in negotiations with Levitt's counsel, Schomaker proposed that petitioner pay Levitt the $50,000 as commissions and redeem Levitt's stock for $1,000. Further, Schomaker proposed to pay Levitt an additional $12,000 in installments, which would also be characterized as commissions (*id.* at 128-129).

Levitt's only concern in these negotiations was to obtain the $50,000 as quickly as possible; he was not concerned with how the transaction was characterized (C.A. App. 201). Accordingly, a Termination Agreement and an Agreement of Sale, as proposed by Schomaker, were entered into between petitioner and Levitt (*id.* at 58-59, 65-68). Pursuant to the agreements, Schomaker changed the notation on the check stub to indicate that the $50,000 was being paid as commissions and then he countersigned a check payable to Levitt (*id.* at 270).

On its 1975 federal income tax return, petitioner deducted $54,800, as commissions paid to one of its employees

(C.A. App. 38-45).[2] The Commissioner disallowed this deduction and issued a notice of deficiency (*id.* at 4-6).[3]

2. Petitioner filed a petition for redetermination with the Tax Court. That court held that the $50,000 payment was in redemption of Levitt's stock and therefore not deductible by petitioner as a business expense under Section 162(a)(1) of the Internal Revenue Code of 1954 (26 U.S.C.), but that the $4,800 was compensation to Levitt and therefore deductible (C.A. App. 262-290).[4] With regard to the $50,000, the court found that the amount paid by petitioner was a close approximation of the actual value of Levitt's stock (*id.* at 281), that Levitt originally understood the payment to be in redemption of stock (*ibid.*) and that Levitt had been adequately compensated for his services by his weekly salary and fringe benefits (*id.* at 282). Accordingly, the court concluded that the Termination Agreement and Agreement of Sale, which characterized the $50,000 as a commission, did not reflect "the substance and reality of the transaction" between Levitt and petitioner (*id.* at 286), and accordingly that petitioner was not entitled to deduct the $50,000.[5]

The court of appeals affirmed by order, finding that the Tax Court's decision was "supported by substantial evidence" (Pet. App. 1a).

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[2]This figure includes the $50,000 check and a $4,800 installment payment, which was characterized as a commission (C.A. App. 271).

[3]The Commissioner also disallowed $4,025 of petitioner's deduction for theft loss (C.A. App. 6). Petitioner did not challenge that deficiency in the Tax Court (id. at 262 n.1).

[4]The Commissioner did not cross-appeal from the Tax Court's determination that the $4,800 was compensation.

[5]The Tax Court recognized that ordinarily the fact that the proposed transaction was, as a tax matter, disadvantageous to Levitt—it would make the $50,000 taxable as ordinary income instead of as capital gain—would be enough to deter him from agreeing to the tax avoidance

3. Petitioner's principal argument (Pet. 23-40) is that under *Frank Lyon Co.* v. *United States*, 435 U.S. 561 (1978), the courts below were required to honor the form in which the parties chose to cast their transaction and that the agreements between petitioner and Levitt indicated that the $50,000 payment was compensation. This argument is plainly without merit.

In *Frank Lyon Co.*, this Court sustained the finding of the district court that there had been arm's-length bargaining between the parties and that the form of the transaction at issue reflected its economic substance (435 U.S. at 577). In the instant case, the Tax Court, in findings upheld by the court of appeals, determined, that because of the circumstances of Levitt's departure there was no real arm's-length bargaining between the parties and that petitioner's characterization of the $50,000 as commissions did not reflect the true substance of the transaction. Contrary to petitioner's claim, the decision below is fully consistent with *Frank Lyon Co.* and similar decisions of this Court, which have held that the tax consequences of a particular transaction ultimately depend on the economic reality of that transaction. See *Commissioner* v. *Court Holding Co.*, 324 U.S. 331 (1945); *Higgins* v. *Smith*, 308 U.S. 473 (1940); *Griffiths* v. *Commissioner*, 308 U.S. 355 (1939). Since the determination of the courts below that the $50,000 was in redemption

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scheme proposed by Schomaker. But the court held that, in the unusual circumstances surrounding Levitt's desire to terminate the relationship as quickly as possible, he did not care how the transaction was characterized so long as he received the money expeditiously (C.A. App. 273, 283).

of stock is purely factual and fully supported by the record,[6] it plainly does not warrant review by this Court.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
*Solicitor General*

SEPTEMBER 1983

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[6]Petitioner argues (Pet. 40-42) that the Commissioner has taken an inconsistent position in the instant case because Levitt reported the $50,000 as ordinary income on his income tax return. The Commissioner, however, has not had occasion to take any position with regard to Levitt's treatment of the $50,000 since Levitt has never sought a refund.

DOJ-1983-09